Nordic Credit Rating

SECTOR COMMENT

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Norwegian savings banks braced for new challenges in 2021

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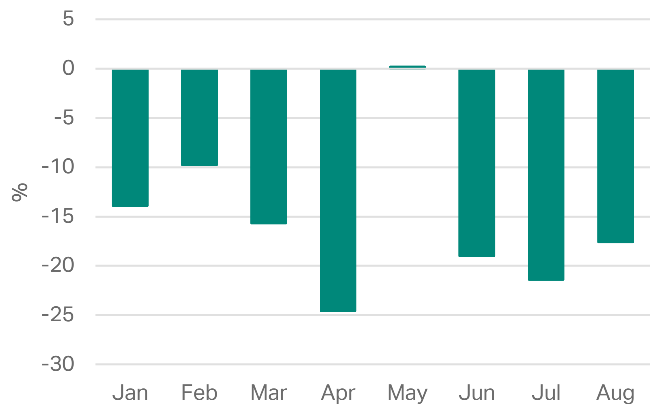
Norwegian savings banks outperformed our earlier expectations the first nine months of 2020. They have, however, taken credit losses based on economic projections, increasing loss reserves against future actual losses. Nordic Credit Rating (NCR) sees risks on the horizon and believes that 2021 could be even more challenging than 2020. Among the major risk factors facing the sector are increasing loan losses, which are normally late cyclical, and margin pressure amid low interest rates. Mitigating factors include cost cutting and increasing lending demand as the cycle turns. In addition, Norwegian banks are generally well capitalised and have access to stable sources of funding.

OUTLOOK STABLE DESPITE CHALLENGING OPERATING ENVIRONMENT

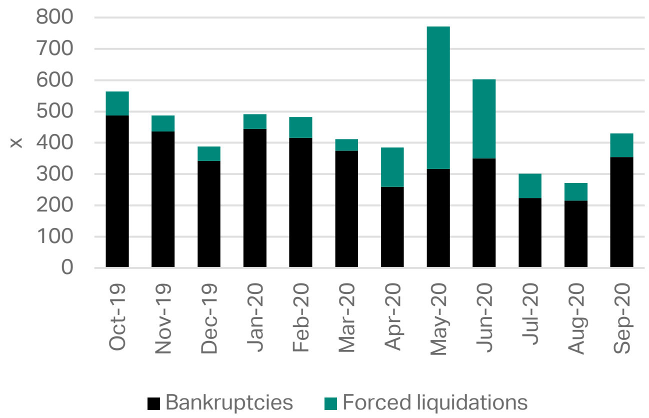
Following our downward revision of Norwegian banks' operating environment to 'a-' from 'a' in April, we believe that the remaining risk factors are more likely to affect individual institutions or banks than the wider banking sector and are better reflected in the outlooks and ratings on individual banks. Political measures in response to COVID-19 are keeping households afloat and companies alive, as illustrated by the low number of debt collection cases and bankruptcies in the first eight months of the year (see figures 1 and 2), but these measures will at some point end. In the following note, we take a look at some of the drivers and challenges facing Norway's savings banks in the coming 12 months.

Figure 1. Year-on-year change in debt collection cases, 2020



Source: Kredinor (22.5% market share in Norway).

Figure 2. Norwegian bankruptcies and foreclosures



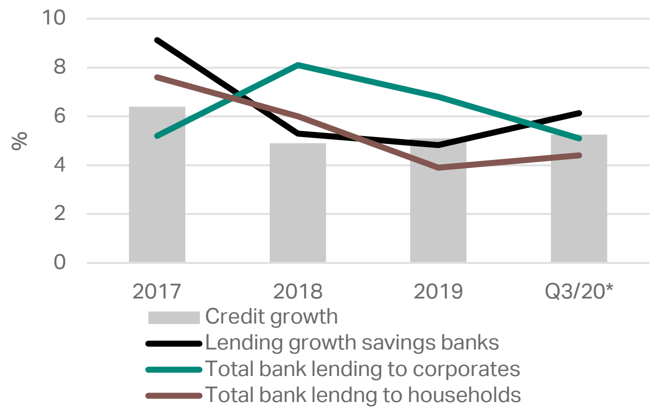
Source: Brønnøysundregistrene.

SUSTAINED LENDING DEMAND; MARGINS UNDER PRESSURE

Norwegian savings banks have in recent years increased their market share of total domestic credit. Given their focus on mortgage lending, this is particularly remarkable considering the relatively strong growth of corporate as opposed to retail lending since 2018. The flip side of the coin, however, is that savings banks have had a relatively weak net interest margin (NIM) than the wider market. Savings banks are mainly funded by deposits (82% of net lending in 2019), and the current low interest rate environment consequently represents a challenge.

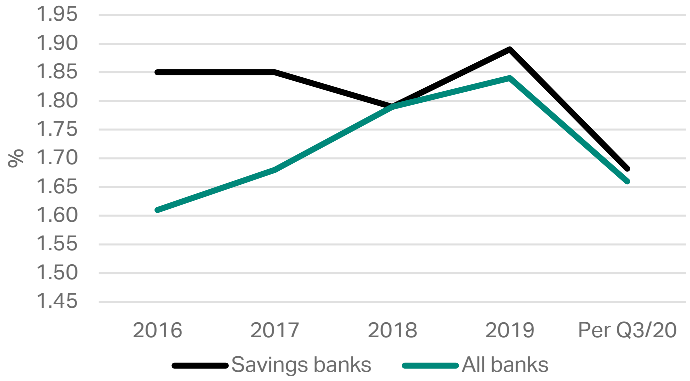
We expect interest rates to remain low through 2021 and anticipate that increasing competition from low-cost lenders will continue to put pressure on lending rates. Accordingly, we expect continued margin decline in 2021, but not as sharply as this year. Any decline is likely to be mitigated by increasing lending growth as the economic cycle improves, particularly in the second half. We do not expect a rebound in fee income before mid-year at the earliest, particularly because of pressure on business volumes and price pressure for payment services.

Figure 3. Growth in bank lending and credit growth



Source: Company data (65 savings banks), Statistics Norway, Finanstilsynet. *Annualised

Figure 4. Net interest margins



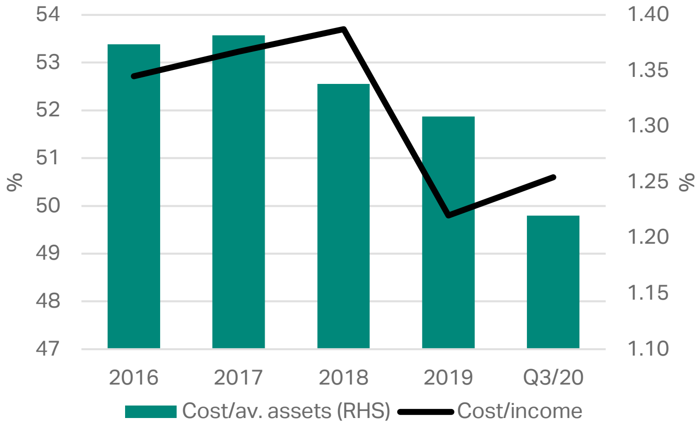
Source: Company data (68 savings

FOCUS ON COST CUTTING AND DIGITALISATION TRIGGERS RESTRUCTURING

Norwegian banks are relatively cost efficient due to a high degree of digitalisation. Cost-cutting efforts appear to have been boosted by margin pressure and increased loan losses, resulting in announcements of reductions of branch offices and mergers through 2020. We expect nominal costs to increase marginally in the years ahead, driven by IT-development costs and, in the short term, normalisation of marketing and travel expenses, while cost metrics are likely to continue on a long-term negative trend. This should help banks sustain a relatively stable level of pre-impairment profit adjusted for trading income the level we have seen in 2020.

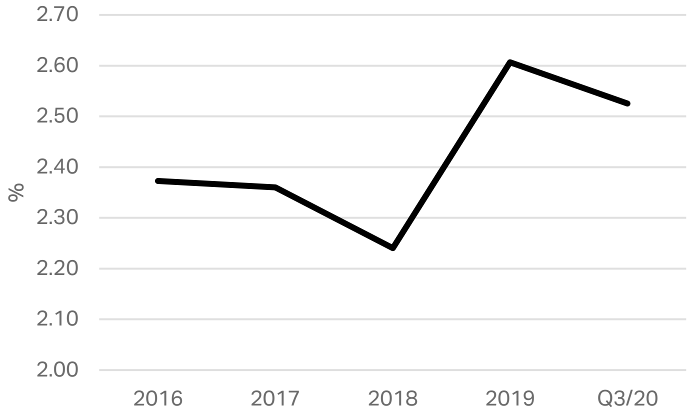
We expect new announcements of cost-cutting plans and anticipate that a long-term decline in the number of savings banks will continue or even increase in pace due to the challenging operating environment. The number of savings banks has fallen by about 30% over the past 30 years, and stood at 96 at end-2019.

Figure 5. Cost/income ex. trading and costs/av. assets, savings banks



Source: Company data (60 savings banks)

Figure 6. Pre-impairment profit to average REA, savings banks



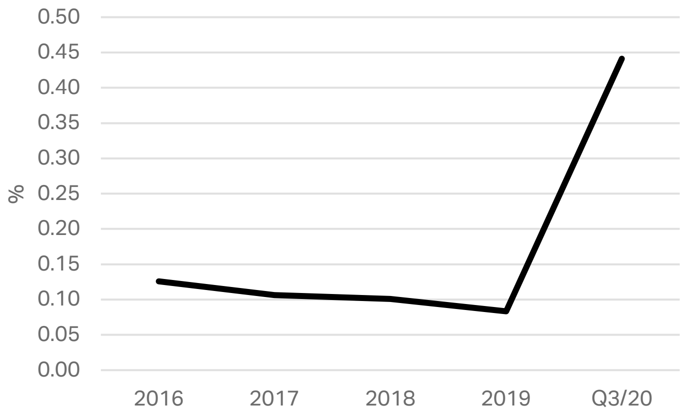
Source: Company data (63 savings banks). REA-risk

LOAN LOSSES ON THE RISE

While Norwegian savings banks increased loan loss reserves in the first quarter of the year, substantial government support programmes have helped keep a lid on actual losses and non-performing loans in the course of the COVID-19 pandemic so far. However, we still see increasing loan losses as a major risk factor for 2021, particularly when the support programmes are eventually ended and companies are no longer able to provide extended credit to customers due to financial stress. In particular, we see a significant likelihood of supply chain problems, long-term shutdowns or low-production levels (under which furloughs could become layoffs), increasing corporate default, and long-term pressure on commercial property prices. Conversely, banks have very little exposure to hotels and restaurants, which have been hardest hit by COVID-19-related restrictions.

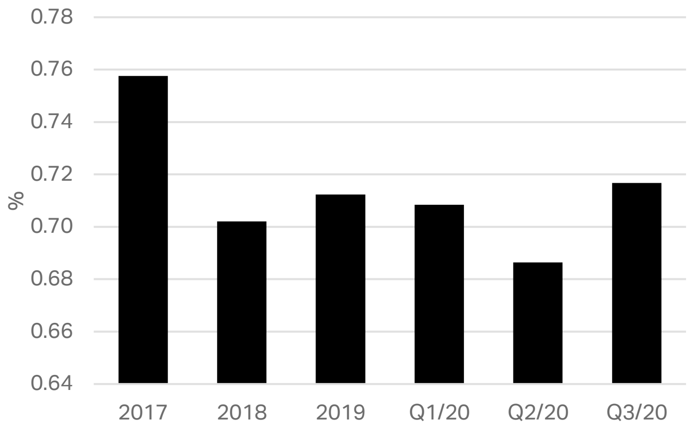
While we expect loan losses over the next few years to be somewhat higher than in recent years, we do not expect loan losses to exceed 0.3-0.5% of lending in the wider banking sector in 2021. However, individual banks could be hit hard, particularly if they run into problems with their commercial real estate exposure. Moreover, oil service exposure remains a risk factor for certain banks.

Figure 7. Loan losses to average loans, savings banks



Source: Company data (66 savings banks)

Figure 8. Net stage 3 nonperforming loans to net loans, savings banks

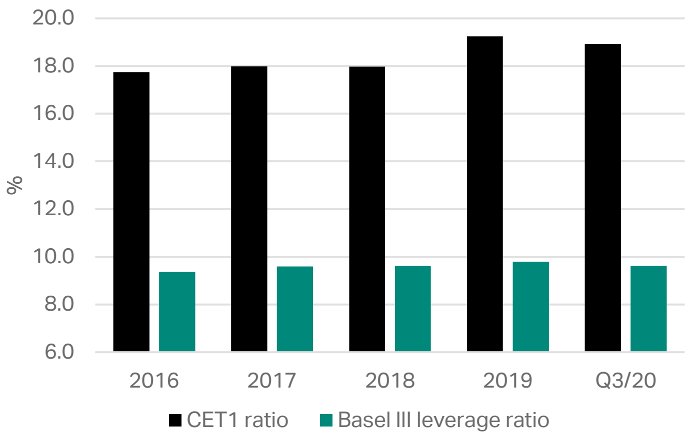


Source: Company data (20 savings banks)

CAPITALISATION LIKELY TO REMAIN STRONG

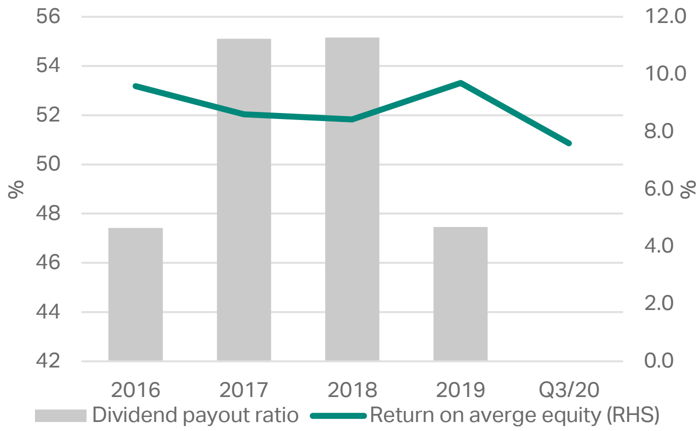
Norwegian savings banks have generally strong capital and leverage ratios and are therefore relatively resilient to increasing loan losses. The significant jump in CET1 ratios in 2019 (see Figure 9) is explained by the implementation of the EU's Capital Requirements Regulation and Capital Requirements Directive. To compensate for this, the systemic risk buffer will be increased by 1.5pp from end-2022 for all banks using the standardised capital model. We also expect that the countercyclical capital buffer, which was cut to 1% from 2.5% in March 2020, will be increased again when the impact of COVID-19 has subsided. Accordingly, we do not expect Norwegian savings banks to reduce their capital any time soon.

Figure 9. CET1 and leverage ratios, savings banks



Source: Company data (65 savings banks)

Figure 10. Return on average equity and dividend payout ratios, savings banks



Source: Company data (65 savings banks, dividend ratio 21 savings banks)

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